No. 10,246

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

SAN JOAQUIN VALLEY POULTRY PRODUCERS ASSOCIATION, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	

MOTION FOR LEAVE TO FILE BRIEF AS AMICI CURIAE AND BRIEF.

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MOTION FOR LEAVE TO FILE BRIEF AMICI CURIAE.

The undersigned, counsel for Messrs. Wayne E. Mayhew and Herman G. Brissman, certified public accountants, respectfully move the Court for leave to file herein the annexed brief *Amici Curiae* herein.

Both counsel for petitioner and for respondent have expressed their consent to its presentation.

Messrs. Wayne E. Mayhew and Herman G. Brissman are certified public accountants doing business as Mayhew, Brissman & Company, having their principal office in the Kohl Building, San Francisco, with branch offices in Chicago and Portland. A substantial part of their work consists of cost accounting for, and auditing the books and affairs of, various cooperative associations. They have

acquired a familiarity with the problems of cooperatives, particularly in the field of finance and taxation.

The problem here presented is, they believe, of vital interest to all cooperatives and of great public importance. It will seriously affect the future welfare and operations of all cooperatives. It is for this reason that this brief has been prepared in the hope it will assist the Court to reach the right conclusion.

Dated, San Francisco,
January 4, 1943.

Respectfully submitted,
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Commissioner of Internal Revenue,
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BRIEF AMICI CURIAE.

PRELIMINARY STATEMENT.

No attempt is made to fully outline the facts developed by the evidence herein, but rather merely to deal with the more general aspects which are of interest to the entire cooperative movement. The petitioner herein, San Joaquin Valley Poultry Producers Association, was organized in 1925 under the provisions of the Agricultural Non-Profit Cooperative Marketing Association Act of California, Secs. 1191-1221, Agric. Code of the State of California, formerly contained in Title XXIII of the Civil Code of the State of California (Secs. 653aa-653xx) as a non-profit cooperative having no capital stock but charging a nominal membership fee of $10.00. It did some business with non-members, but not very much proportionately, and although non-members did not share in "patronage divi-

dends'' they were paid at a higher cash rate than members for their products in order to equalize matters. The funds here involved were derived from deductions from proceeds of sales of members' products and overcharges from purchases on behalf of members. These were placed in certain reserve accounts. Pursuant to resolution of the directors, each member was credited individually on the books with the amounts kept from him under a revolving fund plan whereby the association would keep the funds for a period of time, then return them to the member, replacing them as needed with later funds similarly derived.

These funds are sought to be taxed herein as income to the cooperative, the reason given being that they are the property of the cooperative since the members cannot withdraw their respective shares at will without further action by the board of directors.

Such revolving funds are not at all unusual among cooperatives, particularly non-stock cooperatives; they are one of the few possible ways of raising capital. It is well settled that such funds actually returned to the members within a tax year are not income taxable to the association. The particular issue here presented is whether such funds kept by the association beyond the tax year as a revolving fund ultimately to be returned to members on a patronage basis are to be treated likewise. It is this point which is of prime interest to all non-profit cooperative associations, and it is to shed what light we can upon it that this brief is being filed.

There has been inevitably some confusion in thinking on this subject, natural enough in the process of developing the comparatively new field of cooperative law. But the

underlying principle which governs taxability is, we think, clearly defined and upon it the cases can be pretty well reconciled. Properly understood, they disclose that neither the time nor the actual form of payment is the important thing; rather, it is the existence or non-existence of a definite liability on the part of the association to its members for the return of the moneys on the basis of volume and value of products handled. Where this liability exists, either by virtue of the fundamental law of the association's creation, such as statute, charter, or by-laws, or by virtue of appropriate corporate action such as resolution or book entries, the funds are not income to the association and are not taxable to it. It is only where this liability is not fixed and clear, that the funds are to be considered as property of the association and hence taxable to it.

ARGUMENT.

I. THE BOARD ERRED IN HOLDING THE RESERVES HAD TO BE AVAILABLE AT PATRONS' "UNFETTERED COMMAND" BEFORE THEY COULD BE DEDUCTED FROM PETITIONER'S INCOME TAX RETURN.

Because the reserves in question were not payable to patrons at the latter's "unfettered command"[1] the Board has ruled herein that the patrons' interest had not ripened into ownership and therefore that the funds belonged to the cooperative and were taxable income to it.

There are two errors in this ruling: First, it ignores completely the possibility of an agency and trust relation-

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[1]The phrase is borrowed by the Board from *Corliss v. Bowers*, 281 U.S. 376; it involved taxability to the donor of income from a revocable trust. The case has no bearing here.

ship between the cooperative and its members, assuming that beneficial ownership can exist only where the owner has the right to immediate possession and control of the subject-matter,[2] and second, it assumes that for the cooperative to be entitled to deduct the funds from its gross income, the funds must be *owned* by the patrons, that it is insufficient for the cooperative merely to be obligated to the patrons therefor, unless at least the obligation has ripened into the right of immediate possession.

It is this last erroneous assumption we discuss under this subdivision of our brief. We point out here that as there was an obligation to account to the members for these funds on the basis of the sales and purchases of the individual member, the funds are not taxable, (1) because they do not constitute taxable income and (2) because they are deductible under Section 101 (12), *Revenue Act* of 1936. (49 Stat. 1648.)

(1) The obligation to account to its members for these funds is clear and under Article VIII, sec. 1 of its by-laws (R. 125), and under the special resolutions by the directors. (R. 136-142.) The existence of this obligation as that of an agent, or at least as a borrower, is more fully discussed under Point II. Here we point out that given the obligation, whatever it be denominated, the moneys received under it do not constitute taxable income under the *Sixteenth Amendment.*

Mertens, Law of Federal Income Taxation, Vol. 1, Sec. 5.24;

William H. Stayton, Jr., 32 BTA 940;

Lorenzo C. Dilks, 15 BTA 1294.

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[2]This is discussed under Point II, infra, pp. 17-29.

(2) As to the second point, the amounts that the cooperative is obligated to repay its members are exempt under sec. 101 (12) of the *Revenue Act,* supra, because as hereinafter pointed out, this exemption was incorporated in the statute by Congress by its ratification of administrative rulings and decisions by the Board of Tax Appeals allowing such deduction thereunder.

Our argument hereunder deals with both of these concepts set forth in both (1) and (2) above.

While respondent now concedes (Brief, p. 22) that payment to patrons need not actually take place within the tax year, the Board rules that if the cooperative is to escape taxation the patron must have the *right* to withdraw when and if he wishes. Thus, in effect, it draws an unwarranted distinction between demand obligations and all others, ruling that the latter may not legitimately be deducted from gross income, whereas the former may; and it gives an unjustified emphasis to the time of *payment* of obligations as distinguished from time of *creation* of obligations that has never before occurred.

For obvious reasons, the accumulation of reserves subject to such withdrawal at a patron's will is rare indeed, since such funds would be of no practical value to a cooperative because it could not control them in its time of need. Yet never until the present case, so far as we have been able to find, has the taxability to a cooperative of such funds turned upon whether the patrons could withdraw them at will. None of the cases cited to support the conclusion (*Fruit Growers Supply Co. v. Commissioner,* 56 Fed. (2d) 90, Aff'g 21 B.T.A. 315; *Farmers Union Co-Op v. Commissioner,* 90 Fed. (2d) 488; *Cooperative Oil*

Assn. v. Commissioner, 115 Fed. (2d) 666) actually do so, each being decided upon the lack of existence of an obligation rather than on the right to demand immediate payment.[3]

In creating the distinction, the Board has failed to appreciate and apply the principles underlying cooperatives, substituting the superficial test of "unfettered command" for a real inquiry into the nature of these funds to determine if they truly fall within the definition of taxable income or the exemption of sec. 101 (12) of the *Revenue Act,* supra. The result, besides ignoring basic principles, constitutes discrimination against cooperatives.

The case of *Penn Mutual Life Ins. Co. v. Lederer,* 252 U.S. 523, explains the fundamental principles involved. This decision has been misunderstood, for although the Board's present conclusion is at variance with it, the case (Penn Mutual) is cited by the Board as supporting its ruling. (R. 30.) The case is cited as holding that an insurance company could not deduct from its gross income payments "which had not been actually repaid to them [policyholders] or credited to them within the taxable year". (R. 30.) It is respectfully submitted that such was not the holding of the case, the point not even being before the Court. The funds there involved had all actually been paid or credited to the policyholders within the taxable year. *Thus, there was no presentation of or decision upon the question whether or not payments had been actually paid or credited within the taxable year.* The controversy arose over the insurance company's claim of the right to deduct from its gross income *all* of the funds it had paid

[3]For further discussion of these cases see infra, pp. 16-17, 27-29.

or credited within the tax year, whereas the government contended it could not deduct the part coming from profits on investments, but only that part going to reduce the cost of protection. The Court ruled with the government.

The *Penn Mutual* case is pertinent here, not on the point for which it was cited by the Board, but because the Court therein stated the governing principle which underlies exemptions of this sort, namely, the distinction to be drawn between funds which are actually returns or profit from investments and properly subject to tax, and funds which are strictly in the nature of a reduction in cost of service to a patron and which are in no sense income because they must be accounted for to the patron. The Court discussed at length the dual nature of an insurance company, one phase pertaining to investment and the other to protection. It held that the portion of premiums returned to policyholders as reduced cost of protection was not properly to be considered income to the company; whereas dividends to policyholders representing earnings upon investment were income and properly subject to tax.

This, then, was the basis upon which deduction or taxation was determined, and not whether the funds had or had not been paid over in the taxable year.

The distinction is important for we have here the same type of exemption, although a different exemption statute. The fundamental inquiry here is simply as to the *nature* of these funds i.e., whether they constitute taxable income, and not as to the time of payment or the right of the patron to control them.

The test heretofore consistently relied on to determine this inquiry is, first, determine if a liability exists within

the taxable year for an accounting of these funds;[4] second, if so, determine whether the accounting is to be to *stockholders* on the basis of their *stockholdings* (in which event it is a return on invested capital and its income nature is clearly established), or whether the accounting is to be to patrons on the basis of volume and value of patronage (in which event it represents a reduction in cost or an overpayment and is not taxable income.)

This is illustrated in *Mutual Benefit Life Ins. Co. v. Herold,* 198 Fed. 199, aff'd 201 Fed. 918, cert. den. 231 U.S. 755, cited with approval in *Penn Mutual Life Ins. Co. v. Lederer,* supra. The Court ruled that "dividends" returned to members as a reduction on the subsequent premiums were not income, saying (page 205):

> "This excess payment represents, not profits or receipts, but an overpayment—an overpayment because, being entitled to his insurance at cost and having paid more than it costs, he is equitably entitled to have such excess applied for his benefit. It makes no difference what this excess is called. The question is, what does it represent? Does it in anywise or to any extent represent earnings or profits received by the Company, so as to constitute it a part of its income; or does it merely represent an overpayment?"

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[4] *In Farmers Union Coop Co. v. Commissioner,* 90 Fed. (2d) 488, supra, the funds were taxed because no liability existed. In *Cooperative Oil Assn. v. Commissioner,* 115 Fed. (2d) 666, supra, it was likewise found that the liability did not exist. In the following Board cases deduction was allowed because the liability did exist within the tax year even though not discharged by payment: *Midland Cooperative Wholesale Assn. v. Commissioner,* 44 B.T.A. 824; *Anamosa Farmers Creamery Co. v. Commissioner,* 13 B.T.A. 907; *Farmers Union Coop Assn. v. Commissioner,* 13 B.T.A. 969; *Home Builders Shipping Assn. v. Commissioner,* 8 B.T.A. 903.

See also, *Uniform Printing & Supply Co. v. Commissioner*, 88 Fed. (2d) 75; *Board of Fire Underwriters*, 26 B.T.A. 860; Cf. *Producers Creamery Co. v. United States*, 55 Fed. (2d) 104; and *Farmers Union Co-op Co. v. Comr.*, 90 Fed. (2d) 488, 491, supra.

This difference between profit from investment and return of overpayment or reduction in cost has been recognized consistently from the first. On this theory in Regulation 45, Art. 522, it is provided that though cooperatives acting as purchasing agents were not specifically exempt, nevertheless, their rebates to purchasers should be excluded from gross income. In I.T. 1499, C.B. I-2, page 189, this was extended even to cooperatives organized to do business at a profit (quoting from Article 75, Reg. 33):

> " 'If amounts paid to members are based solely upon quantity of produce furnished, such amounts may be deducted from the gross proceeds of sales, and the taxable net income will be the amount of earnings passed to surplus, or distributable among members upon the basis of stockholdings.' "

In other words, only that portion which passed unquestionably into the hands of the corporation as its own property and thereby became distributable to its stockholders on the basis of their stockholdings rather than on a patronage basis has been considered as belonging and taxable to the association. This decision further said of such rebates (quoted from T.D. 2737, June 19, 1918):

> " 'Like discounts generally, they should appear as an added item of cost in the detailed schedule of cost items submitted with the organization's returns of income.

> "'The ruling is in accordance with settled practice in the administration of the income-tax laws, adopted because the real purpose of such organization was to furnish goods at cost' * * *
>
> "'This office has consistently held that under the Treasury decision and articles of the regulations referred to, cooperative associations even though not exempt from taxation, may deduct from gross income for the years 1917, 1918, 1919 and 1920 the amounts returned to their patrons, whether members or non-members, upon the basis of the purchases or sales, or both, made by or for them. This is upon the theory that a cooperative association is organized for the purpose of furnishing its patrons goods at cost or for obtaining the highest market price for the produce furnished by them. * * *'"

The growth of the treatment accorded reserves is particularly pertinent because that is the type of funds here involved. They were not specifically included in the first exemption statutes; nevertheless, cooperatives were permitted to accumulate them with no thought of taxation. In S.M. No. 57, C. B. 3, page 241 (1920), there was a larger surplus than usual accumulated for 1918 which was not prorated back to the farmers at the close of the year because of uncertainty of the amount of taxes and also because it was desired to improve the cooperative property; some of the funds were used to purchase real estate upon which to build a loading station and were thus quite obviously beyond the patrons' "unfettered command". Neither the fact that this particular cooperative had capital stock (the return on which was limited), nor of its having kept and used the surplus in the manner indicated, deprived it of exemption. The solicitor said:

"The language of subdivision 11 of section 231 is very broad. It was undoubtedly the intention of Congress that a bona fide sales agent for a group of farmers should be exempt from tax. There is no clause in the paragraph which would bar from exemption a corporation of the character of the N Company."

That ruling has never been departed from. The solicitor distinguished the case from two previous decisions wherein tax had been levied upon reserves because under the facts those reserves became the property of the stockholders rather than of the patrons.

Another case squarely in point arising under the *Revenue Acts of 1918 and 1921,* but not decided until 1924, is S.M. 2288, C.B. III-2, page 233. Part of the taxpayer's savings were set aside as a reserve to finance its operations but remained as credits to the patrons in proportion to their purchases and could not inure to the benefit of the stockholders, since they had no claim beyond their limited dividend. It was, therefore, held exempt from tax. Still another case arising under the same act is S.M. 2286, C.B. III-2, page 236, where the cooperative kept back from members and under its own control a reserve to take care of its selling organization and to tide it over lean years. The memorandum says:

"Relative to the reserve, it should be noted that it stands to the credit of subexchanges and local associations and through them to the credit of the individual growers in the very proportion in which fruit is furnished by them, so that such part of the reserve as is not needed to meet losses will *ultimately* revert to the growers *to whom it essentially belongs.*" (Emphasis supplied.)

In 1921 this ruling as to reserves was incorporated in Regulation 62, Article 522, which specifically provided that accumulation and maintenance of a reasonable reserve for stated purposes would not destroy the association's exemption. Nothing in the regulation indicates that the reserves had to be payable to members on demand; indeed such a requirement is repugnant to the very concept of reserves.

Whether this administrative attitude was right or wrong, it was ratified by Congress itself. The exemption statute was amended in 1921 (See 231 (11) Revenue Act of 1921) to encompass the administrative rulings extending the exemption to purchasing agents as well as sales agents; and in 1926 to further broaden the exemption generally to accord with the administrative practice. The Committee report on the 1926 amendment (S. R. 52, Senate Committee on Finance, 69th Congress, 1st Session) commends and adopts the liberal attitude toward the exemption in the following language:

> "The existing law, strictly construed, allows exemption only to those farmers', fruit growers', or like associations which act as sales or purchasing agents for producer members and which return to such members the entire proceeds of their operations, except necessary sales or purchasing expenses. However, *in order that any such association, not operated for profit, and which is a true cooperative association, shall get the benefit of this exemption, the Treasury Department in its regulations has construed the existing law with great liberality,* * * *
>
> "The committee amendment does not broaden the scope of nor even include all the provisions of the Treasury regulations but only incorporates certain

provisions adopted by the Department as fundamental in allowing exemptions to cooperative marketing and purchasing associations. The amendment will assure associations, now exempt, that the liberal construction, by the Department, of existing law, is sanctioned by Congress and if enacted will prevent a valid, but perhaps sudden or drastic, restriction upon exemptions, such as is now possible under existing law." (Emphasis supplied.)

See Mimeograph No. 3886, C. B. X-2, 164, July 9, 1931.

These administrative practices thus became the law through Congressional ratification. *Silas Mason Co. v. Tax Commission,* 302 U.S. 186; *Swayne & Hoyt v. U. S.,* 300 U.S. 297. Even where there is no direct ratification, if such is the fair implication of the Congressional action it is sufficient. *Hamilton v. Dillin,* 21 Wall. 73; *Mattingly v. District of Columbia,* 97 U.S. 687; *Wilson v. Shaw,* 204 U.S. 24; *Charlotte Harbor & N. R. Co. v. Welles,* 260 U.S. 8. So that here, though in the amended statute the Committee literally incorporated only fundamentals, leaving out broad details, the re-enaction of the statute with these amendments, read in the light of the committee's statement, must be considered as an approval of the practices as a whole. None of the Treasury rulings were disapproved.

Following the amendment of 1926 the Board of Tax Appeals has repeatedly followed the same liberal principles, specifically granting deductions in cases analogous to the one here. *Home Builders Shipping Assn.,* 8 B.T.A. 903 (decided in 1927 but involving tax year 1919); *Anamosa Farmers Creamery Co.,* 13 B.T.A. 907 (decided in

1928 but involving tax year 1925); *Farmers Union Cooperative Assn.,* 13 B.T.A. 969 (decided in 1928 but involving the tax year 1920); *Midland Cooperative Wholesale Assn.,* 44 B.T.A. 824 (decided in 1941 but involving the years 1936 and 1937.)

During these years new revenue acts have repeatedly been passed, but never has there been an amendment to override the decisions of the above cases or the administrative practices out of which they grew. This of itself would amount to legislative approval. *Helvering v. Winmill,* 305 U. S. 79, 83; *U. S. v. Dakota Montana Oil Co.,* 288 U. S. 459, 466; *Old Mission Portland Cement Co. v. Helvering,* 293 U. S. 289, 293-4; *National Lead Co. v. U.S.,* 252 U. S. 140, 146.

Thus, Congress has approved a liberal construction of this exemption as a matter of policy. In Point III herein, we show that it is an important part of public policy to favor cooperatives. While exemption and exclusion provisions are generally strictly construed, such provisions begotten of motives of public policy as here involved are not to be so treated. *Helvering v. Bliss,* 293 U.S. 144, 150-151; *United States v. Pleasants,* 305 U.S. 357, 360 aff'g. 22 F.S. 964, 971; *McFeely v. Commissioner,* 296 U.S. 102, 111.

Thus, contrary to the ruling of the Board (R. p. 32) and the claim of the Government (Brief, p. 22) the taxpayer herein is not dependent upon "administrative grace" to support its contentions. This idea evidently comes from certain language used by this Court in *Cooperative Oil Association v. Commissioner,* 115 Fed. (2d) 666, wherein the Court said: "Petitioner does not set forth any theory as to what statute authorizes the deduction even if its

contentions are sound'', but ''in effect asked [the Court] to hold that an administrative practice permitting a deduction not authorized by statute was not liberal enough''. Examination of the briefs discloses that the Court's attention had not been called to the ratification of administrative practice by Congress. However, that part of the Court's opinion was not necessary to its decision, it being sufficient for that purpose that both the articles and the by-laws of the taxpayer specifically *excepted* it from any liability to account to its patrons for the reserves in question on the basis of patronage so there was no basis for the deduction whatever.

Moreover, in the present case, as contrasted with the *Cooperative Oil* case, the petitioner does not rely entirely on this administrative practice, but relies also upon fundamental law which exempts it from taxation upon funds which are not income to it.

In concluding this point, it is respectfully submitted that when the Board ruled herein that members must be entitled to withdraw their funds at will else a cooperative will be taxed thereon, it set up a new standard in conflict with the decisions of the Supreme Court, in conflict with consistent administrative practice ratified and approved by Congress, in conflict with its own previous decisions and in disregard of the true nature of these funds.

II. THE FUNDS UPON WHICH THE TAX IS LEVIED ARE NOT INCOME OF THE COOPERATIVE.

We have shown in Point I that if the funds sought to be taxed constituted ''borrowed'' moneys, they were deduc-

tible under the tax statutes. As hereinafter appears, the relation of lender and borrower at least existed. We believe the obligation was higher, that the moneys in the "Reserve for Zoning Hazard", "Reserve for Security of Membership" and "Reserve Against Loss by Overpayment for Eggs" were held by the cooperative as agent for the benefit of the members. If so, of course, it was not taxable income of the cooperative.

> *Mertens Law of Federal Income Taxation,* sec. 17.07 to 17.12;
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> *Mutual Benefit Life Insurance Co. v. Herold,* 198 F. 199 (affirmed 201 F. 918; *certiorari* denied 231 U. S. 755);
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> *Uniform Printing & Supply v. Commissioner,* 88 F. (2d) 75;
>
> *Board of Fire Underwriters,* 26 BTA 860
>
> *Commissioner v. Berkeley Hall School, Incorporated,* 84 F. (2d) 539;
>
> *Ansco Photo Products v. Clark,* 34 F. (2d) 568.

Cf.

> *Producers Creamery Co. v. United States,* 55 F. (2d) 104;
>
> *Farmers Union Co-op. Co. v. Commissioner,* 90 F. (2d) 488.

The facts are not disputed. Whether or not under them the funds constitute taxable income to the cooperative or, on the other hand, moneys borrowed by it with obligation to repay or held by it as agent for the benefit of its members, is one of law. In determining this question, it is axiomatic that the intention of the parties, i.e., the intention of the cooperative and its members—as disclosed by

the agreement between them, and their actual dealings, governs.

To arrive at the intention of the parties in the instant case we analyze below, first, the intention of the parties as disclosed by the source of the funds; second, the intention of the parties as disclosed by the contract between them; and third, the intention of the parties as disclosed by the ultimate disposition of the funds. We then point out, fourth, that the respondent does not meet the questions presented but assumes the point in issue:

1. The Intention of the Parties as Disclosed by the Source of the Funds.

The cooperative serves its members in two ways; first, it markets their poultry products, and second, it functions for them as a purchasing cooperative.

In respect to the first service, for the years in question (1936 and 1937), it marketed poultry and poultry products by collecting weekly pools of eggs of the members and giving them checks in proportion to each member's contribution at the end of each week. (R. 51, 52.) The amounts received by the members were determined by the Los Angeles market quotations, less expenses. One cent per dozen was authorized to be deducted and placed in an advance fund (by-laws, Art. VIII, sec. 3, R. 127). In respect to the second service, members purchased through the cooperative seed and other supplies. The cost to the members was based on the cost to the association, plus the cost of mixing, delivering and selling, including office (R. 53 and 54) and was fixed slightly above the actual cost plus expenses to preclude any loss. (R. 54.)

The funds held in the reserves came from these two sources, that is, from the deductions on sales and the "overcharges" on purchases. These deductions were set up in the "Reserve Against Loss by Overpayments for Eggs" (R. 68 and 136), and placed on the books to the credit of the individual producer. (R. 71.) The overcharges were also set up in the reserves here attempted to be taxed and placed on the books to the credit of the individual members in proportion to their patronage. (R. 54, 57, 62, 63, 138-146.) Not one penny of the reserves represented moneys from non-members. Some of the retains and overcharges were returned to the members. (R. 59, 137.) No attempt is made to tax the amounts returned.

This manner of dealing between the cooperative and its members—amounting to an accounting by the cooperative to its members—is indicative of an agency and trust relationship, without reference to the agreement between them, hereinafter mentioned.

2. The Intention of the Parties as Disclosed by the Contract Between Them.

The law under which the cooperative is organized, its articles of incorporation and by-laws pursuant thereto, constitute the contract between the cooperative and its members.

Jones v. Missouri-Edison Electric Company, 144 F. 765;

McGarry v. Lentz, 13 F. (2d) 51;

Fawkes v. Farmlands Inv. Corp., 112 Cal. App. 374, 297 P. 47;

18 *Corpus Juris Secundum,* 1147, sec. 477.

The cooperative was organized under the *Agricultural Non-Profit Cooperative Marketing Association Act of California.* (Agric. Code of the State of California, Secs. 1191-1221.) Under that Act, associations so organized are not "organized to make profits for themselves as such, or for their members as such but only for their members as producers". (Section 1192 *Agricultural Code, supra.*) It has no stock, only membership certificates, and it cannot make, declare, or pay to its members any dividend on these certificates. (R. 95.) Thus, its only need for income is for working capital and expenses. But what directly speaks on the intention of the parties is that the cooperative and its members have specifically agreed that the moneys held by the cooperative, after deduction of expenses, shall belong to the members.

In its by-laws, Article VIII, sec. 1 (R. 125), it is provided:

> "The 'net proceeds' shall be such funds as are derived from overcharges on sales and as are left after all expenses shall have been paid, or provided for, all at the discretion of the Directors."
>
> "The 'net proceeds' resulting from the operation of the business, if any, shall belong to the members and shall be known as 'Members' Purchase Credits' and shall be prorated to them in proportion to the amount of business each member has transacted with the association during the period of time in which said 'Members' Purchase Credits' have accumulated."

In this connection, respondent states:

> "It is true that the By-Laws state that the 'net proceeds' shall belong to the members, but this provision apparently refers only to the proceeds of the

> 'purchasing division' of the taxpayers' business."
> (*Respondent's Brief,* p. 20.)

This is not so, for the term is expressly defined to include funds left after all expenses have been paid and all "net proceeds resulting from operations of the business". Moreover, that the proceeds from sales of eggs, including the one cent per dozen retained, were held on behalf of the members is indicated in section 3, Article VIII of the By-Laws. (R. 126, 127.)

Under this agreement, these overcharges and retains (constituting the net proceeds), when actually collected by the cooperative, do belong to the members. Indeed, such amount of it as is actually turned over to members, is recognized by the respondent as theirs, and no tax is attempted to be levied on that amount. It is all very well to characterize such recognition and deductions as "mere administrative grace" or "rebates". There is, of course, no such thing as "administrative grace" in connection with tax liability—it is the legislature, not the administrative officers, who enacts tax laws. Calling it a rebate is merely recognizing it as the moneys of the members in the first place.

Considering this express intention of the parties in connection with the source of the funds hereinabove discussed, we submit that the evidence must be considered as uncontroverted that these "retains" and "overcharges" were held by the cooperative as agent for its members. The creating and setting up of the reserves was a recognition of this. They were set up in lieu of a present distribution with the intention that so far as unused, they would be returned to the members.

The onerous levy here attempted is a tax of the entire reserve before any return of part is made to the members and before any part has been appropriated as working capital of the cooperative. It may be conceded that when portions of the fund are actually appropriated by the cooperative for its own use as working capital, whether to build a new site or otherwise, that portion of the fund becomes the property of the cooperative, but then, and only then, does it become its property, and only then does the question of taxability arise. Even then two hurdles would have to be surmounted before any amounts appropriated to the working capital of the cooperative would be taxable. First, as pointed out in our first point, it would be deductible as an obligation of the cooperative to its members unless released by them; second, as hereinafter pointed out, even if released, it would constitute a tax-exempt voluntary prorata contribution to capital. (See p. 24, infra.)

3. The Intention of the Parties as Disclosed by the Ultimate Disposition of the Fund.

Analysis of their ultimate disposition demonstrates that the funds belong to the members, though held by the cooperative. Let us see what actually may happen to these funds. First, part has been returned to the members and, as pointed out, no attempt is made to tax this part.

Second, part of the funds will eventually be returned to the members. This portion is being taxed as income of the cooperative, although it never has nor will be the property of the cooperative. Third, the remainder of the fund not returned to the members, we assume, may some day be appropriated by the cooperative as working capital. *Whether or not this portion of the fund would constitute*

taxable income of this cooperative need not here be decided, as the tax is here attempted to be levied against the entire fund prior to any such appropriation. In order to complete our analysis, we point out, however, that it is extremely doubtful whether or not even such amounts as may be appropriated would be taxable income of the cooperative. If we assume that the obligation to members therefor is actually cancelled so that this hurdle of treating the moneys as taxable income is done away with, nevertheless, it would amount to nothing more or less than voluntary prorata payment by the members in augmentation of the working capital of the cooperative. Considered such, it would not constitute income under the *Federal Tax Law* but a voluntary contribution. (See *Merten's, Law of Federal Income Taxation,* Vol. 1, p. 200, sec. 5.13; *Commissioner v. Auto Strop Safety Razor Co., Inc.,* 74 F. (2d) 226; *Carroll-McCreary, Inc., v. Commissioner,* 124 F. (2d) 303.

This principle has been covered by *Regulation* 94, Article 22(a)-17:

> "If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary prorata payments by its shareholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company."

But, however that may be, what we desire to particularly point out here is that at this time there is no such point before the Court. There has been no cancellation of the obligation to the members and no appropriation as yet by the cooperative of any of the funds sought to be taxed.

4. The Respondent Does Not Meet the Questions Presented But Assumes the Point in Issue.

Respondent has devoted two pages and three lines to the contention that the funds constitute taxable income to the cooperative. (Respondent's Brief, pp. 19-21.) On page 19, he begs the question, stating: "The net proceeds from the operations of a non-exempt cooperative marketing and purchasing association constitute income to the association". This assumption he supports by the following arguments:

An incorporated cooperative association, like any other corporation, is a distinct corporate entity, existing separate and apart from its members; neither the Agricultural Code of the State of California nor the cooperative's by-laws divest the cooperative of control of the proceeds of its operations and, lastly, the right of members to possess the proceeds is vested in the directors and only part refunded to the members. (Respondent's Brief, pp. 19-20.)

It may be conceded that the cooperative is a corporate entity. But a corporate entity can, and often does act as an agent. *The very purpose for which a cooperative in the instant case was set up, was to act as an agent for its members. Bogardus v. Santa Ana Walnut Growers Association,* 41 Cal. App. (2d) 939, 108 Pac. (2d) 52, *Mountain View Walnut Growers Association v. California Walnut Growers Association,* 19 Cal. App. (2d) 227, 65 Pac. (2d)

80; *Reinert v. Calif. Almond Growers Exchange,* 9 Cal. (2d) 181, 70 Pac. (2d) 190. The law is so clear as to be not subject to dispute and is everywhere recognized. *Texas Certified Cottonseed Assn. v. Aldrich,* 61 S. W. (2d) 79; *Rhodes v. Little Falls Dairy Company,* 245 N. Y. S. 432; *Cunningham v. Long* (Maine), 135 Atl. 198; *Johnson v. Staple Cotton Corp.* (Miss.), 107 So. 2; *Spencer Cooperative v. Schultz* (Wis.), 245 N. W. 99; *Mountain States Beet Growers v. Monroe* (Colo.), 269 Pac. 886; *Yakima Fruit Growers Association v. Henneford, et al.* (Wash.), 47 Pac. (2d) 831.

The above cases involve cooperatives and establish beyond argument that a cooperative may (for that matter, any other legal entity may), act as agent for members or any person.

The argument that the *Agricultural Code of the State of California* and the cooperative's by-laws do not divest petitioner of the proceeds of its operations again begs the question. The point is, *are* the funds held in the reserves the proceeds of the cooperative or its members? The question is one of intention to be gathered by the contract between the parties, as reflected by the governing statute, the Articles of Incorporation and By-Laws of the corporation. And, the by-laws specifically provide that these reserves belong to the members.

Respondent's argument, that the rights of members to possess the proceeds is subject to the discretion of the directors, is based on the by-laws' permitting the setting up of reserves. The establishing of reserves is not incompatible with an agency relationship.

Conceding, for the purpose of argument, that the rights of members to possess these funds is within the directors' discretion, this would only indicate that the cooperative, besides acting as agent, holds the property with power to appropriate a portion for its working capital. This is a well recognized relation between cooperatives and their members. *Bogardus v. Santa Ana Walnut Growers Association, supra; Mountain View Walnut Growers Association v. California Walnut Growers Association, supra; Reinert v. California Almond Growers Exchange, supra; Texas Certified Cottonseed Assn. v. Aldrich, supra; Rhodes v. Little Falls Dairy Company, supra; Cunningham v. Long, supra; Johnson v. Staple Cotton Corp., supra; Spencer Cooperative v. Schultz, supra; Mountain States Beet Growers v. Monroe, supra; Yakima Fruit Growers Association v. Henneford, supra.*

It is equally well recognized in other relationships of agency. *Morley v. University of Detroit,* 263 Mich. 126, 248 N. W. 570; 90 *A. L. R.* 464; *Rusco v. Ryan,* 153 Pac. 1162, 54 Okla. 641; *Coburn v. Davis,* 207 N. W. 586, 201 Iowa 1253 (agent to sell lots and account to principal after deducting commission); *Weaver Piano Co. v. Curtis,* 155 S. E. 291, 158 S. C. 117.

These fundamental concepts of law have been overlooked in the case at bar in deciding the case against the taxpayer.

Respondent cites the following cases as supporting its assertion that the reserves are taxable income of the cooperative: *Farmers' Union Co-op. Company v. Commissioner,* 90 F. (2d) 488; *Cooperative Oil Ass'n v. Commissioner,* 115 F. (2d) 666; *Fruitgrowers' Supply Co. v. Com-*

missioner, 56 F. (2d) 90; *Callaway v. Farmers' Union Co-op. Association,* 119 Nebr. 1, 226 N. W. 802.

In *Farmers' Union Co-op. Company v. Commissioner, supra,* the validity of our argument is recognized. The Court in that case held, however, that under the statutes and the cooperative's articles and by-laws, the money upon which a tax was levied was, in fact, the cooperative's money. The Court said:

> "Its [petitioner's] relation to this money must be determined by the law under which it was organized and operates. Among the statutory powers are to 'make by-laws for the management of its affairs, and to provide therein * * * for the distribution of its earnings'."

Facts in that case showing that the funds taxed belonged to the cooperative and not the members were: the cooperative had full power to provide *"for the distribution of its earnings"* (Court's italics); distribution was required only *"in part"* (Court's italics) to be on a patronage basis; and no action had been taken by the directors to fix a liability for any part to be so distributed; and the by-laws, after providing for surplus, required, *"there shall be paid an annual dividend from the net profits of 8 per cent on the par value of all the paid capital stock".* (Court's italics.) In answering the contention that there was no profit to the corporation, the Court said:

> "This argument would acquire force and would require examination here if such were the situation of petitioner. The reason why such argument is not here applicable, is that distribution of earnings was not required by the governing statutes, the articles

of incorporation, or the by-laws to be confined to patrons."

In the case at bar, there is no capital stock, no dividends; it is expressly provided in the by-laws that the net proceeds "shall belong to the members", and the directors had acted to acknowledge the liability and set it up on the books to the credit of the patrons.

Cooperative Oil Ass'n v. Commissioner, supra, is similarly distinguishable. It is discussed herein, pp. 16-17.

In *Fruitgrowers' Supply Company v. Commissioner, supra,* the Court simply ruled that as the petitioner was engaged in the business of purchasing supplies and furnishing supplies to non-members, it was not doing the type of business exempted by law, and its profits thus derived were taxable and constituted income of the corporation. It was an ordinary corporation, no evidence of agency or creditor and debtor relationship was presented.

Hallaway v. Farm, Etc. Coop. Ass'n, supra, was a suit to recover a patronage dividend. It was held no dividend had been declared. It is pertinent to nothing here involved.

In conclusion on this point, we point out that the effect of the tax is to penalize what is universally recognized as sound business practice in connection with cooperatives. If the funds upon which the tax is levied had all been returned to the members, there would have been no tax. The fact that the return of it has been delayed, pending possible appropriation of part to the working capital of the cooperative, is seized upon by the Commissioner as an excuse to claim that all the funds comprising this reserve is taxable income to the cooperative.

III. THE DECISION REVERSES THE SETTLED POLICY OF THE LAW, DISCRIMINATING AGAINST, INSTEAD OF IN FAVOR OF, COOPERATIVES.

It has been the settled policy of the law to favor cooperatives, even to discriminate in their favor as against other business ventures. We respectfully refer the Court to the appendix, herein wherein is discussed the growth and extent of this policy. Under the decision of the Board of Tax Appeals in this case, this policy is reversed. We have already seen how, in effect, it refuses to cooperatives any tax benefit from the existence of their obligations with the exception of demand obligations—a situation which obtains with no other taxpayer. Likewise it denies to them the application of the usual principles of the law of agency. We propose to now show how it attacks and dries up their only source for obtaining adequate capital funds by levying a tax on those funds, a tax which the ordinary corporation completely escapes. To get the full significance of this situation, let us examine it in more detail.

There are at most only four ways for a cooperative to raise its working capital: (1) sale of capital stock; (2) membership fees; (3) borrowings, or (4) pro rata contributions.

The sale of capital stock as in the case of the ordinary business corporation is not possible with non-stock associations such as petitioner herein; it has never been adequate even with stock associations, since they are not organized for profit, and capital is not attracted where returns are limited. This method which ordinary corporations have and which is tax exempt is therefore denied the cooperative.

Membership fees have proved inadequate and of declining importance:

> "As a means of securing subscriptions to capital, the membership fee is constantly declining in importance. This is for the reason that experience has shown that only nominal fees are satisfactory and that, after all, the most consistent and reliable source of revenue will arise from deductions or retains after the association is in operation."
>
> (Evans & Stokdyk, *Law of Cooperative Marketing*, pp. 164-165.)

The third method, borrowing, if confined to borrowing from banks or professional lenders is satisfactory only as to supplementing capital raised otherwise, but is obviously unsound and impractical as the exclusive or even the principal means of raising capital.

But borrowing from patrons in the form of deductions or retains from their accounts, revolving the funds thus borrowed at convenient periods, has proved easy, practical and within the spirt and purpose of the cooperative movement. It means that those who use the association most contribute the greatest amount. Because of the obvious advantages, it has become the common practice for associations to thus raise their principal capital funds on a revolving fund basis, much as petitioner has done herein. (See: *Bogardus v. Santa Ana Walnut Growers Assn., supra.*) Evans & Stokdyk, *Law of Cooperative Marketing*, have this to say (p. 174):

> "A common practice in dealing with membership contributions is to handle them in the form of revolving funds. This practice contemplates the repayment of the first contributions to capital when the desired

amount of fixed and operating capital is obtained. It assumes, of course, that new contributions to capital will be made constantly. * * * Several of the older and better established cooperatives now revolve from one fifth to a third of their capital each year. An association should not be bound, however, to revolve any portion of its capital at any given time. Exigencies might easily arise which would embarrass an association so bound."

Borrowed money does not constitute taxable income:

> "Moneys received by way of a loan do not constitute taxable income. Obviously such receipts do not fall within the concept of income as that term is used in the Sixteenth Amendment, and no attempt has been made in any of the Revenue Statutes to reach and tax such receipts as income." (*Mertens, Law of Federal Income Taxation,* Vol. 1, Sec. 5.24.)

Even where the obligation for the funds borrowed is forgiven by the shareholder of a corporation, it does not create taxable income. Reg. 94, Article 22 (a)-14:

> "* * * In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt."

Moreover pro rata contributions to capital from shareholders of a corporation are excluded from taxable income. Reg. 94, Article 22(a)-17, quoted supra, p. 24; Mertens, *Law of Federal Income Tax,* Vol. 1, Sec. 5.13.

Now whether these retains are considered as moneys held on behalf of the patrons, borrowed money or as pro rata contributions should make no difference as to taxa-

tion; they should be deductible in any of these events. To refuse to consider them in either of these classes, or, so considering them, to deny their exclusion from income is to reverse the policy of the law favoring cooperatives with a vengeance. It would confine cooperative financing almost exclusively to professional money lending agencies—an utterly inadequate source; and it would deny to members of cooperatives the rights accorded to shareholders of a profit-making business corporation, viz.: the making of a tax-free contribution to its capital.

We respectfully submit that the decision is wholly untenable. If permitted to stand, the non-profit cooperative will find itself under such a burden that its whole utility may be destroyed.

Dated, San Francisco,
January 4, 1943.

Respectfully submitted,
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(Appendix Follows.)

Appendix.

Appendix

REVIEW OF POLICY FAVORING COOPERATIVES.

Although the beginnings of the cooperative movement go well back into the nineteenth century, its modern development is of comparatively recent origin and has received its greatest impetus from the fact that the ordinary business corporate structure has been found utterly unsuited to the economic welfare of the farmer. The trend of the existing commercial corporation is in the direction of constantly increasing size and the throwing of control into the hands of fewer and fewer men. By reason of the very nature of agriculture, such a method of handling its business has been shown wholly unsuitable, and tended to widen the breach between the producer and consumer and to permit the building of large middleman profits at the expense of both. The result has been a tremendous impetus to the nonprofit cooperative, which is at once mutual in its character and decentralized in its control. The fundamental difference between the two theories is thus pointed out by Mr. Justice Brandeis in *Lewis K. Liggett Co. v. Lee,* 288 U.S. 518:

> "But Americans seeking escape from corporate domination have open to them under the Constitution another form of social and economic control—one more in keeping with our traditions and aspirations. They may prefer the way of cooperation, which leads directly to the freedom and equality of opportunity which the Fourteenth Amendment aims to secure. That way is clearly open, for the fundamental difference between capitalistic enterprise and the cooperative—between economic absolutism and industrial democracy

> —is one which has been commonly accepted by legislatures and the courts as justifying discrimination in both regulation and taxation."

It is worthy of note that Mr. Justice Brandeis also wrote the Court's opinion in *Penn Mutual Life v. Lederer, supra.*

The essential purpose of ordinary corporations is profit; they are resorted to as a means of exempting individuals from personal liability while at the same time affording opportunity for profits. The departure of the cooperative principle from this concept has been well expressed by Gerald B. Henderson, in 23 *Columbia Law Review,* p. 91:

> "The profit incentive is the mainspring of commerce, but is the antithesis of cooperation. The cooperative principle requires its services be performed for the cooperating members by their appointed representatives and not by independent business units, dealing at arm's length and striving for profits. It implies that the cooperating members are the real parties in interest in any transaction undertaken by their association. At no time can the association as a corporate entity have any interest in the marketed product adverse to the interest of the members, for whose benefits the operations are conducted. Yet, so far as it is possible, without sacrificing this essential characteristic, the association must adapt itself to the usages of trade. The merchant who buys its product, the banker who lends it money, properly insist that there be a responsible legal entity with which dealings can be had, that the property contributed by the members be subjected to the hazards of the venture in which it has been launched, that the officers of the association have the powers normal in the conduct of trade, and that no secret and unusual restrictions

> hamper their authority in ordinary business transactions. By conferring on the association legal title with the powers of disposition which are incident to legal title, the members have successfully achieved this result. *By insisting that this legal title exists for a special and limited purpose, for the benefit only of those who deal with the association in good faith and in the normal course of business, the rights of the members as the real parties of interest are preserved.*" (Italics supplied.)

Responding to the very definite need for better facilities in agriculture and in other fields lending themselves to cooperative ventures, both the state and the federal government have enacted numerous laws, authorizing and encouraging cooperatives. Those having a capital stock somewhat similar to the ordinary corporation were first in the field. By 1900 some eleven states had enacted laws permitting this type of cooperative, and since that time nearly every state in the union has followed suit. The earliest law of the non-stock type was passed in California in 1895 (*Session Laws* of 1895, Chapter 183), and similar acts have gradually extended from that date to other states. The movement has, of course, not been without opposition. The greatest hurdle to overcome was the charge that such organizations constituted restraints on trade. It is generally recognized today, however, that they are legitimate because they are beneficial to the public at large. (Evans & Stokdyk, *Law of Cooperative Marketing*, pp. 5 to 18.)

The Federal Government itself has legislated to foster and encourage cooperatives. In 1914 the *Clayton Act* was

passed containing a clause exempting from the act non-stock cooperative associations (38 Stat. 731, 15 U. S. C., Sec. 17); in 1922 this exemption was enlarged to include both stock and non-stock cooperatives (42 Stat. 388, 7 *U. S. C.,* Sec. 291); also in 1922 the *Capper-Volstead Act* expressly authorized cooperative associations. (42 Stat. 388, 7 *U. S. C.* Sec. 451.) Aid of an affirmative nature has also been provided. The *Federal Cooperative Marketing Act* (44 Stat. 802, 7 *U. S. C.* Sec. 451) was passed to bring about the development upon a broad and unified basis of a marketing system for agricultural products. In 1923 the *Intermediate Credit Bank Act* (39 Stat. 360, 12 *U. S. C.* Sec. 641), provided additional credit facilities for cooperatives. In 1933, the *Farm Credit Act* set up twelve regional banks for cooperatives, one in each of the twelve federal land bank districts. (42 Stat. 1454.) In *Liberty Warehouse Co. v. Burley Tobacco Growers Coop,* 276 U. S. 71, 92-93, in commenting on the fact that up until 1928, forty-two states had enacted cooperative statutes, the Supreme Court said:

> "Congress has recognized the utility of cooperative associations among the farmers in the *Clayton Act;* the *Capper-Volstead Act,* and the *Cooperative Marketing Act of 1926.* These statutes reveal widespread legislative approval of the plan for protecting of scattered producers and advancing the public interest."

The Court gave the reason for this attitude as follows:

> "The opinion generally accepted—and upon reasonable grounds, we think—is that cooperative marketing statutes promote the common interest. The provisions for protecting the fundamental contracts against inter-

> ference by outsiders are essential to the plan. This court has recognized, as permissible, some discrimination intended to encourage agriculture * * * and in many cases it has affirmed the general power of the state so to legislate as to meet a definitely certain evil."

The revenue acts have themselves from the beginning of the modern income tax contained exemptions designed to favor cooperatives which the Treasury Department until now has construed liberally, with Congress approving that policy. (see Brief, supra, pp. 11-17.)